INDEX.

	PAGE
Questions Presented	1
Applicable Provisions of Internal Revenue Code (26 U. S. C. 1946 ed.)	2
Statement	2
Reasons for Granting the Writ	3
(1) There is here involved an important question of income tax law now bathed in a sea of doubt by reason of the uncertain metes and bounds growing out of three decisions of the Supreme Court	4
(2) The lower courts are now in conflict	5
(3) The decision of the Court of Claims is opposed to reason and justice	6
(4) The principle at issue is of general concern to both government and taxpayer in the administration of the tax laws, and needs the determination of this court to eliminate further litigation	8
Conclusion	8

TABLE OF CASES CITED:

Boos v. *Reynolds*, 84 F. Supp. 185 (D. C. Minn.), affirmed by U. S. Court of Appeals for the Eighth Circuit, March 16, 1951, —— F. (2d) ——	5, 6
Commissioner v. *Jacobson*, 336 U. S. 28	4, 5
Helvering v. *American Dental Co.*, 318 U. S. 322	4, 5
Liberty Mirror Works, 3 T. C. 1018	7
U. S. v. *Kirby Lumber Co.*, 284 U. S. 1	4

OTHER AUTHORITY CITED:

Internal Revenue Code (26 U. S. C. 1946 ed.), Section 22	2

IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. .

THE MARSHALL DRUG COMPANY,

Petitioner,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Chief Justice of the United States and Associate Justices of the Supreme Court of the United States:

Petitioner, by J. S. Seidman, its counsel, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims, entered in the above entitled case on March 6, 1951.

Question Presented.

Did petitioner receive taxable income or a non-taxable gift on the cancellation by trade creditors of open account debt owing them by petitioner?

The Court of Claims held it was taxable income on the theory that where business debts and dealings are involved, there can be no gift.

Applicable Provisions of Internal Revenue Code (26 U. S. C. 1946 ed.).

Sec. 22. GROSS INCOME.

(a) General Definition.—"Gross income" includes gains, profits, and income * * * derived from any source whatever * * *.

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this title: * * *

(3) Gifts, bequests, and devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

Statement.

Petitioner, an operator of a chain of retail drug stores, though having more assets than liabilities, was in a bad financial way in 1940 as a result of losses due to inept management. It then owed 947 trade creditors $521,860.

It asked its creditors for help in putting through a reorganization that would bring in new management. In response, over 80% of the claims were converted into preferred stock at par. Some creditors went further and put in fresh cash for preferred stock at par.

The creditors who did not convert their claims into stock were contacted by letter, in person, and by phone to invoke their sympathy and persuade them to make a contribution to petitioner's financial situation by

cancelling a part or all of their claims. Trade creditors with claims of $10,838.79 refused to budge and they were paid in full. However, trade creditors with face amount of claims of $72,848.80 agreed to take $46,696.11 and cancelled the remaining $26,152.69. It is with these cancellations that this case is concerned.

The cancellations varied from 10% to 100% (the latter applying to claims totalling $4,817.82). These percentages were based on the creditor's own arbitrary determination of the extent they were willing to help petitioner. To each such creditor petitioner sent an acknowledging letter of gratitude.

The creditors thought, with or without investigation, that full collection of their accounts could not be made and wrote off the cancelled amounts as a bad debt.

No controversy existed as to the amount of petitioner's debts. Petitioner never offered to buy the accounts from the creditors. No promise or obligation was made by petitioner to the creditors in return for the cancellation of their claims.

Reasons for Granting the Writ.

The reasons for granting this writ may be summarized as follows:

(1) There is here involved an important question of income tax law now bathed in a sea of doubt by reason of the uncertain metes and bounds growing out of three decisions of the Supreme Court.

(2) The lower courts are now in conflict.

(3) The decision of the Court of Claims is opposed to reason and justice.

(4) The principle at issue is of general concern to both government and taxpayer in the administration of the tax laws, and needs the determination of this court to eliminate further litigation.

Each of these will be discussed in sequential order.

(1) There is here involved an important question of income tax law now bathed in a sea of doubt by reason of the uncertain metes and bounds growing out of three decisions of the Supreme Court.

Three Supreme Court decisions were rendered on the subject of debt cancellation. Chronologically, the first was *U. S.* v. *Kirby Lumber Co.,* 284 U. S. 1, which held that the purchase by the debtor, in the open market, at a discount, of an undefaulted bond before maturity, results in taxable income to the extent of the discount. Then came *Helvering* v. *American Dental Co.,* 318 U. S. 322. It held that the voluntary cancellation by a creditor of part of back rent and interest on notes for merchandise claims, was not the realization of income to the debtor but a tax-free gift. Finally, came *Commissioner* v. *Jacobson,* 336 U. S. 28. It was also a bond case, and held that the *Kirby Lumber Company* principle holds good even though the bond is not bought in the open market, but was acquired by direct negotiation with the holders.

In the *Jacobson* case, the court explained that a bond situation is one where there is not likely to be a good climate for a gift. On the other hand, when an open account is involved, the court said a gift is more likely to arise.

All of these cases involved business debts and business dealings. The Court of Claims, on its own, without anything to go by from the pronouncements of the Supreme Court, and in fact contrary to the holding in the *American Dental Co.* case, ruled that business debts and business dealings, *per sese,* preclude the possibility of gift.

To justify this conclusion, the Court of Claims says that the *Jacobson* case limited the doctrine of the *American Dental Co.* case. Actually, what the Court of Claims is saying is that the *Jacobson* case emasculated or reversed the *American Dental Co.* case. The Supreme Court never so indicated or implied. In fact, the Supreme Court expressly excluded from the automatic area of the *Jacobson* case cancellation of open-account trade debts.

At all events, as things now stand, and in the face of the Court of Claims decision, confusion is both created and augmented on the whole important subject of the tax treatment of debt cancellation. The problem cries for reconciliation and finality of expression from the Supreme Court. The need and opportunity to do so are afforded by this petition.

(2) The lower courts are now in conflict.

The Court of Claims decision holds that the *Jacobson* case limited the doctrine of the *American Dental Co.* case. In *Boos* v. *Reynolds,* 84 F. Supp. 185 (D. C. Minn.), the court held just the opposite, as follows:

> "Finally, nothing said by the Supreme Court in *Commissioner* v. *Jacobson* (Jan. 17, 1949), 336 U. S. 28 (69 S. Ct. 358), wherein the question of gifts was again before the court, may be taken

to indicate disapproval of the decision in the *American Dental Co.* case."

The *Boos* case, which was affirmed by the U. S. Court of Appeals for the Eighth Circuit on March 16, 1951, —— F. (2d) ——, is ignored entirely in the Court of Claims decision. The *Boos* case has a factual setting somewhat akin to the present case, but comes off with the opposite conclusion. *There, too, business debts were involved.* A landlord cancelled back rent as part of a lease extension program. The court held that the cancellation was gratuitous in that it "gave the donor nothing which he did not otherwise have." That is exactly what is involved in the present case, except that the Court of Claims held it taxable income. It requires the voice of the Supreme Court to dissolve the conflict.

(3) The decision of the Court of Claims is opposed to reason and justice.

The idea that there can be no gifts in business flies in the face of reason, no less the decisions already cited. Though no business debts were involved, the cancellation was a gratuitous act. There was no market place, no catch-as-catch-can negotiation. Petitioner was a suppliant soliciting financial aid. In response, the creditors voluntarily cancelled part or all of the claims.

The Court of Claims confused the motive for an act with the act itself. Some creditors were influenced by the prospect of continued business with a reinvigorated company. That explains why they were willing to make a gift, but does not change the fact

of gift. The creditors were at no time compelled to act. What they did, when, and how much they did, were of their own free determination. Petitioner gave nothing in exchange. That constitutes a gift, or else the word has no meaning.

The very fact that on the one hand, creditors who did not want to go along were paid in full, and on the other, many creditors forgave the debt in full, shows that the situation was entirely in each creditor's hands to do with as he wanted. To be sure, petitioner was interested in getting the maximum gift and the creditors undoubtedly wanted to minimize the amount, but that does not change its aspect as a gift. Frequently, a solicitor of charity suggests an amount larger than the donor has in mind and some negotiation ensues before the figure is determined, but what is finally paid is still a gift to the charity.

The fact that the creditors accounted for the amounts cancelled as bad debts, not charitable contributions, is likewise besides the point. Bookkeeping treatment does not pervert the underlying facts. In *Liberty Mirror Works*, 3 T.C. 1018, a bank gratuitously forgave the unpaid portion of the taxpayer's debt. The bank treated that portion as worthless. The Tax Court said (p. 1023):

> "The bank may have considered all of the debts worthless to the extent of the amounts forgiven. In any event, we think that, under the rule of the Supreme Court in the *American Dental Co.* case, the canceled portion of the indebtedness was not taxable income to the petitioner."

Petitioner does not contend that all cancellations of business debts are nontaxable gifts. On the other

hand, not all cancellations of business debts preclude the existence of gifts. That is where the Court of Claims fell in error and needs the corrective guidance of the Supreme Court.

(4) The principle at issue is of general concern to both government and taxpayer in the administration of the tax laws, and needs the determination of this court to eliminate further litigation.

Debt cancellations arise frequently in every day business life. It is important in the administration of tax laws that their treatment be defined. The significance of the subject is shown by the fact that three times it has been welcomed beyond the threshold of this court. It now knocks again because doubts have been engendered that, unless put at rest, will create a high degree of uncertainty for government and taxpayer alike, and result in a multitude of litigation.

Wherefore, petitioner prays that this petition for a writ of certiorari be granted.

April, 1951.

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INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	3
Argument	7
Conclusion	10

CITATIONS

Cases:

Boos v. *Reynolds*, 84 F. Supp. 185, affirmed, March 16, 1951	9
Commissioner v. *Jacobson*, 336 U. S. 28	7, 8, 9
Helvering v. *Amer. Chicle Co.*, 291 U. S. 426	7
Helvering v. *Amer. Dental Co.*, 318 U. S. 322	7, 8, 9
United States v. *Kirby Lumber Co.*, 284 U. S. 1	7, 9

Statutes:

Internal Revenue Code, Sec. 22 (26 U.S.C. 1946 ed., Sec. 22)	2, 7

Miscellaneous:

Treasury Regulations 103, Sec. 19.22(a)-14	3, 7
Treasury Regulations 111, Sec. 29.22(a)-13	3